UBS House View

Europe
Chief Investment Office WM

Weekly

2 June 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	1.1%	6.3%	3.7%
Euro Stoxx 50		–1.0%	3.3%	–4.2%
MSCI EM		0.5%	5.6%	2.4%
FTSE 100		–0.9%	2.5%	1.6%
SMI		–0.4%	4.6%	–3.9%
NIKKEI 225		–1.3%	–0.3%	–12.2%
US high grade bonds	UW	0.2%	1.4%	3.5%
Euro high grade bonds	UW	0.1%	1.0%	4.5%
US investment grade bonds	OW	0.4%	4.3%	5.2%
Euro investment grade bonds		0.1%	2.1%	3.1%
US high yield bonds		0.2%	5.8%	7.1%
European high yield bonds	OW	0.1%	5.1%	4.2%
EM sovereign bonds		0.2%	4.4%	6.8%
EM corporate bonds		0.2%	5.1%	6.6%

Source: Bloomberg, UBS as of 2 June 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** had a mixed week, with the S&P 500 advancing 1.1% while the Euro Stoxx 50 declined 1%. The Nikkei 225, the worst-performing major index this year, fell another 1.3%.
- **Investment grade bonds** had a good week in the US, rising 0.4% – taking year-to-date gains to 5.2%. US high yield bonds climbed 0.2% and European ones 0.1%.
- **In foreign exchange** markets, the pound was the biggest loser against the US dollar, falling 1.7%. The yen and New Zealand dollar gained the most ground, 0.8% and 0.9% respectively.

In focus

Fed hints at approaching rate rise. US Federal Reserve chief Janet Yellen said the Fed should raise interest rates "in the coming months" if jobs and inflation continue to pick up. *CIO is expecting two rate increases this year.*

US consumer spending rises by most since 2009. The 1% increase in personal spending for April on the prior month should lay to rest worries that US consumers are running out of steam. *CIO is expecting US GDP growth of 1.5% this year. Higher consumer spending should aid earnings growth – we're overweight US stocks.*

Abe shelves plans for VAT hike. The Japanese PM Shinzo Abe has said he will delay the scheduled 2 percentage point VAT increase (from 8% to 10%). Instead of taking place in April 2017, it will now occur in October 2019, a timeframe likely subject to whether Abenomics succeeds in reviving domestic growth. *CIO is neutral on Japanese equities.*

Deflation deepens in Japan. The official goal of 2% inflation seems like a distant one. The headline CPI came in at –0.3% in April, year on year, down from 0.1% in March. There was little cheer either in the core measure, which strips out fresh food prices. That will add to pressure on the Bank of Japan to ease further.

Decade high for US pending home sales. A lot of housing sales are in the pipeline. Signed contracts to buy existing homes rose 5.1% in April to the highest level since early 2006. *CIO believes the US economy will gather pace in the second half of the year and into 2017.*

The greenback's comeback. After a three-month losing streak, the trade-weighted US dollar was up almost 3% for May, its best month since November. A more hawkish tone from Fed officials has been key. *CIO expects a firming USD versus the EUR in the near term (toward EURUSD 1.10 in three months), but believes the US dollar will retreat again to EURUSD 1.16 in 12 months, as the Eurozone economy gains strength.*

Record-low German jobless rate. Unemployment in Europe's largest economy dropped to 6.1% for May, the lowest rate since reunification. (On the harmonized measure for April, the figure was 4.2%.) Maybe that will encourage Germans, who cut back retail spending in April by 0.9%, to part with more of their money. Overall, the German economy remains in good shape. *CIO expects GDP growth of 1.6% this year, slightly more than the US's 1.5%.*

Eurozone prices still falling. Zero inflation for Germany in May was a hopeful sign of ebbing deflationary pressures, after prices fell 0.3% in April. But data on Tuesday showed the Eurozone price index declined for a fourth consecutive month (–0.1%). *CIO is neutral on Eurozone equities and overweight euro-denominated high yield bonds.*

Canadian economy cools. GDP grew 2.4% annualized in the first quarter, missing the 2.8% consensus forecast. The data was released a week after the nation's central bank scaled back GDP forecasts for the second quarter, as forest fires in Alberta curbed oil output. *CIO recently removed its overweight position on the Canadian dollar versus the Australian dollar.*

UBS

Deeper dive

Can gold keep its shine?

Mark Haefele

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Watch this week's [UBS House View Weekly Video]

Gold has been among the best performers this year. The precious metal has outshone equity markets and high yield bonds with a gain of nearly 15%, to trade at USD 1,215 an ounce.

But can gold retain its appeal during a period of rising US federal funds rates? It gave up some of its gains in May after the Fed indicated that monetary tightening is likely in the coming months – a scenario many in the markets had come to consider improbable.

Most of gold's rally is probably over for now. We believe the Fed will hike rates twice in 2016 – an outcome to which markets still assign only a 41% probability. This faster pace of tightening should put gold under pressure over coming months, since higher rates raise the opportunity cost of holding the metal. As a result, it is possible that gold could slip below USD 1,200 over the next three months.

Still, we believe the downside for gold is limited over a 12-month horizon, and there are three main reasons gold should be trading close to current levels in a year's time.

1) **Falling real rates:** While nominal US interest rates are heading higher, we believe that real interest rates – nominal rates minus inflation – are likely to fall in the months ahead. The recent rise in the oil price and tight labor markets make it probable that the inflation rate will climb. Meanwhile, the Fed remains in go-slow mode and is unlikely to accelerate rate hikes even if inflation climbs modestly above its official target of 2%. A negative real interest rate erodes the purchasing power of cash, making real assets, like gold, more attractive.

2) **Rising production costs:** The price of mining gold fell in recent years due to lower energy costs and the sliding value of the currencies of many emerging nations, where the bulk of gold is extracted. Now this process is reversing. The recovery in the oil price and EM currencies is making mining more expensive again, which should support the global price somewhat.

3) **Long-term growth in China and India:** Economic growth rates in the two countries are an important determinant of the gold price. Both have a cultural affinity for gold, and jewelry demand rises as middle class incomes expand. Last year China and India accounted for almost half of global demand for the metal. US citizens, by contrast, were responsible for just 4% of purchases. While China is slowing, it still looks set for GDP growth of 6.6% this year, compared to 1.5% for the US. India is likely to be the world's fastest growing large economy both this year and next.

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Bottom line

Talk of upcoming Fed rate hikes has caused gold to give up some of this year's gains. But we believe that the downside for gold is limited. Real US interest rates – the key determinant of the gold price – are likely to fall further into negative territory. In 12 months we forecast gold to be near its current price of USD 1,200 an ounce.

Regional view

US presidential election – how does it matter for Europe?

Podcast
www.ubs.com/podcast

Bill O'Neill
Head Investment Office UK

"The US is likely to exhibit greater reluctance to take a leadership role in promoting free trade."

International media attention is increasingly turning to November's US presidential election. The primary voting is almost complete and the presumptive Republican and Democratic Party candidates, Donald Trump and Hillary Clinton, are now identified. I thought it appropriate to look at some of the campaign issues relevant to us here in Europe by calling on the opinions of our CIO US colleagues. The following points emerged from the discussions "across the pond."

Trade: This week alone saw a bout of political nerves over progress on the Transatlantic Trade and Investment Partnership (TTIP) – an ambitious EU-US agreement aimed at cutting tariffs, integrating regulations in key sectors and improving market access on both sides. The aim is to get the deal agreed and enacted before the end of the Obama Administration. That now hangs in the balance as domestic resistance hardens in France and Germany, which are concerned about messy compromises on regulations and freer trade in agricultural goods.

Clinton's previous support for the corresponding Trans-Pacific Partnership (TPP) has eroded in the face of opposition by US trade unions. Trump has used strong language to disparage the trade pact as poorly negotiated and worthy of rejection. Members of Congress, vulnerable to voter backlash in an election year, are in no hurry to back the deal.

The mediocre pace of the recovery, stagnating real wages in many sectors and high personal debt burdens have all played a role in increased voter disaffection and profound skepticism in the political process. Multinational trade agreements make easy targets. Regardless of who is elected in November, the US is likely to exhibit greater reluctance to take a leadership role in promoting free trade regardless of its merits.

Security: The US is also weary of warfare and anxious to extricate itself from geopolitical conflicts far from home. It exhibits a tendency to favor isolationist foreign policies periodically. Trump's skepticism about NATO should be viewed in this light. While support for NATO has been a given for 65 years, Trump's rhetoric has struck a chord among some Americans anxious about their economic prospects and the amount of national treasure being spent on sectarian conflicts without an easy resolution. If he wins the election, the merits of NATO as a vehicle for military and political cohesion should prevail. But the willingness of the US to shoulder the economic burden of the organization may diminish. This would have clear ramifications for European defense spending commitments at a time of austerity, in particular the US demand that all NATO members devote 2% of annual GDP to defense, and perhaps more in future.

Healthcare: For some individual sectors, the US election result carries significant weight. Healthcare is one example. While a topic of heated debate on the campaign trail, the prospects for turning campaign rhetoric into viable legislation appear poor. Trump's main focus is to repeal and replace Obamacare, but it remains to be seen if he could devise a plan to cover the more than 17 million previously uninsured Americans. Clinton's campaign rhetoric regarding drug prices has obscured the larger issue that Democratic proposals tend to favor healthcare companies, largely due to insurance coverage expansion. That is to say that, in general, healthcare companies (and by extension, healthcare stocks) should perform better when more Americans are covered by health insurance.

Kind regards,
Bill O'Neill

I would like to thank Thomas McLoughlin and Brian Nick of CIO WM Research, WM Americas, for their insights.

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